89-1502 (1)

Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

AMERICAN STOCK EXCHANGE, INC., CHICAGO BOARD OPTIONS EXCHANGE, INCORPORATED, and THE OPTIONS CLEARING CORPORATION,

Petitioners,

v.

CHICAGO MERCANTILE EXCHANGE, BOARD OF TRADE OF THE CITY OF CHICAGO, PHILADELPHIA STOCK EXCHANGE, INC., and SECURITIES AND EXCHANGE COMMISSION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT (SEVENTH CIRCUIT NOS. 89-1763 and 89-1786)

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QUESTIONS PRESENTED

1. Is a financial instrument that is offered and sold to the public as an investment, traded on national securities exchanges, and cleared and settled in the same manner as other securities, subject to plenary regulation by the Securities and Exchange Commission under the federal securities laws or by the Commodity Futures Trading Commission under the Commodity Exchange Act?

2. What are the meanings of the terms "contract of sale of a commodity for future delivery," "option," and "privilege" for the purpose of allocating jurisdiction over new financial instruments between the Securities and Exchange Commission and the Commodity Futures Trading Commission? Is an expansive interpretation of "futures contract" appropriate and consistent with Congressional intent if the effect is to prevent the application of the federal securities laws to innovative investment instruments?

3. Is a financial instrument that gives the purchaser a perpetual privilege to receive the value of an index of common stocks (or a privilege to acquire the stocks comprising the index) a "privilege on any . . . group or index of securities (including any interest therein or based on the value thereof)" subject to the jurisdiction of the Securities and Exchange Commission under Section 9(g) of the Securities Exchange Act of 1934?

LIST OF PARTIES

The proceedings in the Court of Appeals arose on petitions for review of orders of the Securities and Exchange Commission approving, pursuant to the provisions of the Securities Exchange Act of 1934, as amended, proposed rules changes of the petitioners and of the Philadelphia Stock Exchange, Inc. The parties to the proceedings before the Court of Appeals were as follows: the petitioners were the Chicago Mercantile Exchange, the Board of Trade of the City of Chicago, and the Investment Company Institute; the respondent was the Securities and Exchange Commission; and the intervening respondents were the petitioners herein* and the Philadelphia Stock Exchange, Inc. Although the Commodity Futures Trading Commission was not a party before the Court of Appeals, it filed a brief and presented an oral argument, as *amicus curiae*, on behalf of the positions taken by the Chicago Mercantile Exchange and the Board of Trade of the City of Chicago.

* Pursuant to Rule 29.1 of the Rules of this Court, petitioners state that they have no parent companies or subsidiaries (other than wholly owned subsidiaries), except that (i) National Securities Clearing Corp., Securities Industry Automation Corp., and The Depository Trust Company are non-wholly-owned subsidiaries of the American Stock Exchange, Inc., and (ii) The Cincinnati Stock Exchange is a non-wholly-owned subsidiary of Chicago Board Options Exchange, Incorporated. The stock of the applicants is not publicly traded. Control of the applicants is vested in their respective members.

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Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners, American Stock Exchange, Inc., Chicago Board Options Exchange, Incorporated and The Options Clearing Corporation respectfully request that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit entered on August 18, 1989, in two companion cases (Nos. 89-1763 and 89-1786).

OPINIONS BELOW

The opinion of the Court of Appeals, which is reproduced in the Appendix beginning at App. 1, is reported at 883 F.2d 537 (7th Cir. 1989). The order of the Securities and Exchange Commission which was the subject of review in No. 89-1763 appears in the Appendix beginning at App. 26 and is published at 54 Fed. Reg. 15,280 (1989). The order of the Securities and Exchange Commission which was the subject of review in No. 89-1786 appears in the Appendix beginning at App. 84 and is published at 54 Fed. Reg. 15,575 (1989). The opinion of the Court of Appeals denying the petitions for rehearing is reported at 883 F.2d 550 (7th Cir. 1989) and is reproduced in the Appendix beginning at App. 108.

JURISDICTION

The judgment of the Court of Appeals was entered on August 18, 1989. The order denying the timely petitions for rehearing in both cases was entered on October 23, 1989. By order entered January 12, 1990, this Court extended the time for the filing by petitioners of a petition for a writ of certiorari to and including March 22, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1) (1988).

STATUTES AND REGULATION INVOLVED

This case involves Sections 3(a)(10), 9(g), 25(a) and 28(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), 15 U.S.C. §§78c(a)(10), 78i(g), 78y(a) and 78bb(a) (1988); Section 2(a)(1) of the Commodity Exchange Act, as amended (the "CEA"), 7 U.S.C. §§2, 2a (1988); and Securities and Exchange Commission Rule 9b-1, 17 C.F.R. §240.9b-1 (1989). The pertinent portions of the texts of these provisions are set forth in the Appendix beginning at App. 112.

STATEMENT OF THE CASE

Petitioners American Stock Exchange, Inc. ("AMEX") and Chicago Board Options Exchange, Incorporated ("CBOE") are registered with the Securities and Exchange Commission ("SEC") as national securities exchanges pursuant to Section 6 of the Exchange Act, 15 U.S.C. §78f (1988). Both exchanges maintain exchange markets for options to purchase and sell underlying common stocks and government securities, as well as options based on the value of underlying stock indexes. AMEX also maintains exchange markets in a wide variety of other types of securities, including common and preferred stocks, warrants, rights, and corporate bonds and debentures.

All of the options which are traded on AMEX and CBOE, as well as the options which are traded on three other national securities exchanges,[1] are issued by petitioner The Options Clearing Corporation ("OCC") and are publicly offered and sold to the public as registered securities under the provisions of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. §§77a-77aa (1988), and Rule 9b-1 under the Exchange Act, 17 C.F.R. §240.9b-1 (1989), which is the options disclosure rule of the SEC. OCC has responsibility for the settlement of all transactions in options which are effected on national securities exchanges, and is registered with the SEC as a securities clearing agency pursuant to the provisions of Section 17A of the Exchange Act, 15 U.S.C. §78q-1 (1988).

Following the break in the securities markets in October, 1987, studies by the SEC's Division of Market Regulation and the New York Stock Exchange, as well as recommendations and testimony by the SEC, suggested that the listing and trading of "baskets" of stocks could help ameliorate the volatility and steep price declines that had been experienced during and after the market break. (App. 67-68). The SEC's staff study also noted that trading in market baskets could provide greater efficiencies than trading in the individual stocks and that this would add an additional layer of liquidity to the stock market to help absorb velocity and concentration of trading. (App. 68). Moreover, it was noted that trading in market baskets would eliminate some of the market information limitations that are present in the trading of the individual stocks. (App. 68-69). It was also believed that market baskets would provide an alternative vehicle for retail investors "to invest in 'the market'." (App. 69).

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[1] Securities options are traded on the New York Stock Exchange, the Philadelphia Stock Exchange and the Pacific Stock Exchange as well as on AMEX and CBOE.

The Philadelphia Stock Exchange, Inc. ("PHLX"), AMEX and CBOE, together with OCC, created a new type of market basket instrument, called an "index participation" ("IP"), which was designed to permit retail investors to make investment decisions based on the direction of the market as a whole (App. 69) and to receive the equivalent of the dividend income flowing from a basket of stocks. IPs were designed to trade as market baskets and to furnish the advantages which the studies of the market break had noted would be associated with the trading of market baskets. (*See* App. 70).

The IPs designed by all three exchanges were perpetual instruments which conferred on their holders a present interest in the current value of a specified portfolio (or basket) of stocks comprising an underlying index. (App. 27 and 86). Essentially, the purchaser of every IP acquired two basic rights. First, the purchaser acquired the right to receive a quarterly dividend equivalent equal to the regular cash dividends accrued over the quarter which an owner of the specified portfolio of stocks would be entitled to receive. (App. 27). Second, the purchaser acquired the privilege to receive, upon exercise, an amount of cash based on the value (or a multiple of the value) of the underlying index of securities, and, in the case of the IP designed by the AMEX, the alternative privilege under specified circumstances to receive physical delivery of the shares of stocks comprising the index. These privileges were exercisable on dates specified by the exchange which created the particular IP. The IPs traded on PHLX were exercisable daily,[2] the IPs traded on AMEX were exercisable quarterly, and the IPs traded on

[2] If the purchaser exercised on a fixed quarterly date, he was entitled to receive 100% of the value of the underlying index; if he exercised on any other day, he was entitled to 99.5% of such value. (App. 28).

CBOE were exercisable semi-annually.[3] (App. 87-88). The IPs designed by CBOE also gave the seller the privilege to exit his position by paying the value of the index. This privilege was also exercisable semi-annually. (App. 29-30).

Assuming that the exchanges succeeded in establishing liquid markets for the trading of IPs, the holder of an IP (like the holder of any other security) would have had the ability to sell his IP in the market at any time and to realize a profit or loss in that fashion. The seller of an IP would have had the ability to terminate his obligation at any time by purchasing an offsetting IP in the market.

In many respects, IPs were designed to resemble the standardized options that were traded on the exchanges and issued and cleared by OCC. Thus, IPs were to be treated on the same basis as standardized securities options for purposes of meeting the registration requirements and customer disclosure obligations of the 1933 Act, the Exchange Act, SEC Rule 9b-1, and the exchanges' rules (App. 75-76); fixing customer protections in connection with marketing (App. 78); fixing position and exercise limits (App. 79-80); halting and suspending trading (App. 80); issuance, clearance and settlement (App. 80, 89-93, and 100-02); providing the mechanisms for exercise and allocating exercise notices (App. 30-31 and 89-90); maintenance of clearing house margin (App. 102); and providing for the pledge of the instrument (App. 102-03). The trading rules of the exchanges applicable to options and other securities and the general clear-

[3] The Court of Appeals' statement that IPs "are settled quarterly" on the same dates as futures contracts (App. 17) is simply wrong. Apart from the fact that the IPs designed by PHLX are exercisable more frequently and those by CBOE less frequently, the Court's statement ignores that IPs are perpetual and that "settlement" will never occur unless the purchaser exercises his privilege.

ance and settlement rules of OCC applicable to options were also made applicable to IPs. IPs were thus designed to be traded and cleared in the same manner as options and other securities, and not to be traded and cleared like futures contracts.[4]

In early 1988, the three exchanges and OCC filed with the SEC, as required by Section 19(b) of the Exchange Act, 15 U.S.C. §78s(b) (1988), proposed modifications to their existing rules to provide for IPs. The SEC published notices of the proposals and invited public comments thereon. Respondents Chicago Mercantile Exchange ("CME") and the Board of Trade of the City of Chicago ("CBT"), as well as the Commodity Futures Trading Commission ("CFTC"), filed comments arguing that the SEC lacked jurisdiction to approve the IPs rules of the exchanges and OCC on the ground that IPs were not a "security" within the meaning of the securities laws and in any event were "contracts of sale of a commodity for future delivery" ("futures contracts") and therefore subject to the exclusive jurisdiction of the CFTC under the provisions of the CEA. (App. 37-38 and 85 at n. 7). The SEC also received comments from the Investment Company Institute ("ICI") arguing that IPs were investment company

[4] There are significant differences between the trading and clearance procedures for securities and the procedures applicable to futures. For example, securities exchanges have specialists and market-makers who are obligated, under exchange rules, to help maintain fair and orderly markets. *See, e.g.*, AMEX Rules 170 and 958, CCH American Stock Exchange Guide ¶¶ 9310 and 9758; CBOE Rule 8.7, CCH Chicago Board Options Exchange Guide ¶ 2277; PHLX Rule 1014, CCH Philadelphia Stock Exchange Guide ¶ 3014. Traders on futures exchanges have no obligation to maintain fair and orderly markets. Futures clearing systems permit daily realization of profit and loss through variation margin payments (*see* S. Rep. No. 1131, 93rd Cong., 2d Sess., at 17, *reprinted in* 1974 U.S. Code Cong. & Admin. News 5843, 5857-58. In contrast, securities clearing systems permit realization of profit and loss only when securities are disposed of.

securities subject to the provisions of the Investment Company Act of 1940 (the "ICA"), 15 U.S.C. §§80(a)-1 to 80(a)-64 (1988). (App. 37).

On April 11, 1989, the SEC entered orders approving the proposed rules modifications of the three exchanges (Appendix B) and OCC (Appendix C). The SEC determined that IPs were securities[5] and not futures and the trading of IPs was subject to its regulatory jurisdiction (App. 46) and that IPs were not investment company securities subject to the ICA (App. 66). The SEC found that "IPs will provide retail investors with a cost efficient means to make investment decisions based on the direction of the market as a whole" (App. 69) and that "the listing and trading of IPs on national securities exchanges may reduce market volatility associated with program trades of stock." (App. 68). The SEC found all of the rules proposals to be consistent with the applicable provisions of the Exchange Act.[6] (App. 82 and 107).

Pursuant to Section 25(a) of the Exchange Act, 15 U.S.C. §78y(a) (1988), CME and CBT filed petitions to review the SEC orders approving the proposed rules of the three exchanges (No. 89-1763) and OCC (No. 89-1786).[7]

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[5] The SEC found that IPs possessed the key characteristics of stock (App. 49-52) and to the extent that IP characteristics differed from those of stock, they resembled the characteristics of rights to purchase or puts or calls on a security or index of securities (App. 52).

[6] The SEC also issued an order under its Rule 9b-1 approving the disclosure document for IPs prepared by OCC and the exchanges (Order Approving Proposed Index Participations Disclosure Document, SEC Release No. 34-26752, 43 SEC Docket 1144 (April 21, 1989)), as well as an order declaring OCC's registration statement for IPs under the 1933 Act to be effective. (SEC File No. 33-28140 (April 21, 1989)). No appeal was taken from those orders.

[7] Two other petitions to review were filed in the Court of Appeals. The first (No. 89-1538), which was filed by CME and CBT,

(Footnote continued on following page)

Decision Of The Court Below

On August 18, 1989, the Court of Appeals rendered its opinion. The thrust of the Court's decision was that IPs did not fit comfortably within either the definitions of "security" under the securities laws or the traditional meaning of "futures contracts" under the CEA. The Court stated that IPs had properties similar to those of a security from the purchaser's perspective and properties similar to a futures contract from the seller's perspective.[8] (App. 2-3). The Court then held that, although IPs did not have all of the attributes of conventional futures contracts, there was no more reason strictly to construe the reach of the CEA than that of the securities laws—that if IPs were securities then they were also futures contracts subject to the exclusive jurisdiction of the CFTC under the provisions of Section 2(a)(1) of the CEA,

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[7] *continued*
was dismissed by the Court of Appeals for want of jurisdiction. The second (No. 89-2012) was filed by the ICI to reverse the SEC's determination that IPs were not investment company securities subject to the ICA. The Court of Appeals did not decide the issues raised by ICI's petition in light of its disposition of Nos. 89-1763 and 89-1786. (App. 25).

[8] Section 25(a)(4) of the Exchange Act, 15 U.S.C. §78y(a)(4) (1988), provides that the findings of the SEC as to facts are conclusive when supported by substantial evidence. Yet the Court of Appeals ignored the SEC's finding that IPs provided a vehicle for retail customers to invest in the market, which would have clearly established them as securities. *Reves v. Ernst & Young,* U.S. , 58 U.S.L.W. 4208 (February 21, 1990) ("Congress therefore did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment." 58 U.S.L.W. at 4209.) On the other hand, the Court of Appeals supplied a finding—one never made by the SEC—that sellers of IPs see the IP "as a speculative or hedging instrument scarcely distinguishable from a futures contract that terminates on the cash-out day." (App. 3). It is unclear what the basis was for the Court of Appeals' intuition regarding the states of mind of sellers of IPs.

7 U.S.C. §§2, 2a (1988). Accordingly, the Court of Appeals set aside the SEC's orders approving the IPs rules of the three exchanges and OCC.[9]

The Court of Appeals noted that the portion of the definition of "security" in Section 3(a)(10) of the Exchange Act, 15 U.S.C. §78c(a)(10) (1988), which most closely matches an IP is the language, which was added by the 1982 amendments to the securities laws (Act of October 13, 1982, Pub. Law 97-303, 96 Stat. 1409), covering a "privilege on any security . . . or group or index of securities (including any interest therein *or based on the value thereof*)" [emphasis in original]. (App. 15). The Court stated in as many words that "IPs convey privileges based on the value of an index." (App. 15). However, for reasons that do not appear on the face of the opinion, the Court did not consider the applicability of another section added by the 1982 amendments—Section 9(g) of the Exchange Act, 15 U.S.C. §78i(g) (1988)—which provides that "[n]otwithstanding any other provision of law, the [SEC] shall have the authority to regulate the trading of any . . . privilege on any . . . group or index of securities (including any interest therein or based on the value thereof) . . . ."

Ignoring the significance of its finding that IPs convey privileges based on the value of an index (and that consequently the SEC had the authority under Section 9(g) of the Exchange Act, "[n]otwithstanding any other provision of law," to regulate the trading of IPs whether or not IPs were

[9] During the pendency of the proceedings before the Court of Appeals, the SEC orders were not stayed by either the SEC or the Court of Appeals. Trading in IPs commenced on the AMEX and PHLX, but not on the CBOE. After the Court of Appeals issued its opinion, but before its mandate was effective, all trading of IPs was terminated by the exchanges and the open positions in outstanding IPs were closed out in accordance with the rules of OCC.

also options), the Court focused instead on its conclusion that "an IP is not an option on a security." (App. 17). Even that conclusion is questionable in the extreme. In reaching it, the Court limited the definition of option to what it regarded—without support in the record[10]—to be the paradigm for standardized options. Yet, the Court did not say why options should be construed in a narrow, crabbed way to deny the SEC's jurisdiction to regulate them, while, at the same time, giving a broad and expansive meaning to "futures contracts."

On October 23, 1989, the Court of Appeals issued another opinion, prompted by the petitions for rehearing and suggestions of rehearing *en banc* of the petitioners, the SEC, and PHLX. In that opinion the Court made it clear that it regarded IPs as both securities and futures contracts—that is, as "investment vehicles" from the perspective of the purchasers and as instruments that "look like futures contracts" from the perspective of the sellers. (App. 109). If IPs are futures contracts, then, the Court held, the CFTC has exclusive jurisdiction under Section 2(a)(1)(B)(ii) of the CEA. *Id.* Again, the Court failed to address—directly or otherwise —the applicability of Section 9(g) of the Exchange Act.[11] The

[10] The Court erroneously stated that "options are written 'out of the money' " (App. 18); that the "writer retains dividends" (App. 18); and that options, unlike futures, "call for delivery of the underlying instruments." (App. 11). In fact, options are often written "in the money" (were they not, options would become illiquid as soon as they became profitable to exercise); options traded in the over-the-counter market are generally adjusted for dividends and standardized options are adjusted for certain extraordinary dividends; and all index options, like futures, are cash-settled. Indeed, Section 28(a) of the Exchange Act, 15 U.S.C. §78bb(a) (1988), was amended in 1982 for the express purpose of preempting state laws that might otherwise have invalidated cash-settled options and other cash-settled securities traded on national securities exchanges. *See* H.R. Rep. No. 626, 97th Cong., 2d Sess., pt. 1 at 9, *reprinted in* 1982 U.S. Code Cong. & Admin. News 2780, 2787.

[11] OCC called this issue to the Court's attention in three separate briefs, and this point was accepted and endorsed by the SEC in one of its briefs.

Court also noted, in response to an argument made by PHLX, that even though the IPs traded on PHLX gave holders the right to exercise the privilege on a daily basis, those IPs still had the requisite element of futurity because the holders received only 99.5% on the index value. (App. 110). The Court did not decide whether an IP with a daily privilege to receive 100% was a futures contract, nor did it explain why the 0.5% difference should determine which agency has regulatory jurisdiction. (App. 110).

REASONS FOR GRANTING THE WRIT

I.

THE RESOLUTION OF THE KEY ISSUE RAISED BY THIS CASE—WHICH FEDERAL REGULATORY SCHEME WILL GOVERN INNOVATIVE FINANCIAL INSTRUMENTS—WILL SHAPE THE FUTURE DEVELOPMENT AND COMPETITIVENESS OF THE NATION'S FINANCIAL MARKETS.

This case presents, as a matter of first impression, a fundamental jurisdictional question under two different statutory schemes (the federal securities laws and the CEA) that is of vital importance to the development and regulation of the trading markets for a growing number of new types of financial instruments. The resolution of this question will not only determine which federal agency has regulatory authority over these instruments, it will also have important consequences for the development and competitiveness of the nation's financial markets. It will determine the type of market in which these new instruments may be traded and the forms they will take, the manner in which professional participants in those markets will be regulated, and the nature and extent of the statutory protections that will be available to public investors.

Whether these financial instruments are subject to regulation by the SEC or CFTC is not, therefore, simply a "turf" battle between two federal agencies. Rather, the resolution of this question will determine which of two distinct sets of regulatory protections is available to public investors. For example, if these new instruments—which are sold as investments and deemed to be securities from the perspective of the purchaser[12] —are subject to regulation under the securities laws, then public investors are entitled to the benefit of a number of regulatory safeguards, including: the disclosure obligations of the 1933 Act and, in this case, of SEC Rule 9b-1, the regulatory protections of the State securities laws,[13] and the insurance protections afforded by the Securities Investor Protection Act of 1970, as amended, 15 U.S.C. 78aaa-78*lll* (1988). If, however, these instruments are subject to the exclusive jurisdiction of the CFTC under the CEA because they "look like" futures contracts from the perspective of the sellers (App. 109), then these safeguards will not be available to public investors. Thus, this Court's determination as to the choice of regulatory schemes intended by Congress is a matter of great importance to public investors.[14]

[12] "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called." *Reves v. Ernst & Young*, 58 U.S.L.W. at 4209 [emphasis in original].

[13] Section 28(a) of the Exchange Act, 15 U.S.C. §78bb(a) (1988), expressly preserves the jurisdiction of State securities laws insofar as they do not conflict with the provisions of the Exchange Act. In contrast, State regulatory laws are totally preempted with respect to matters that are within the exclusive jurisdiction granted to the CFTC under Section 2(a)(1) of the CEA, 7 U.S.C. §§2, 2a (1988).

[14] Neither this Court nor the Court of Appeals has ever examined whether the existence of the regulatory scheme established by the CEA renders the protections of the securities laws unnecessary for public investors. *See, e.g., Reves v. Ernst & Young*, 58 U.S.L.W. at 4211; *Marine Bank v. Weaver*, 455 U.S. 551, 557-59 (1982).

Moreover, the resolution of this question will determine whether these new forms of securities, which provide small investors with the ability to invest in market baskets of common stocks, will be subject to the regulatory scheme established by Congress for the purpose of "preventing the excessive use of credit for the purchase or carrying of securities." Section 7(a) of the Exchange Act, 15 U.S.C. §78g(a) (1988). In contrast, no federal authority has the jurisdiction to set, or to oversee the setting of, levels of margin on futures contracts subject to the exclusive jurisdiction of the CFTC. Sections 5a(12) and 8a(7) of the CEA, 7 U.S.C. §§7a(12) and 12a(7) (1988). Thus, if these instruments are deemed to be futures contracts as well as securities, one of Congress' major purposes in enacting the Exchange Act will have been thwarted.

The question as to which regulatory scheme applies will also determine the type of market in which the instruments will be able to be traded, the form of the instruments, and the qualifications of the persons authorized to sell and to trade them. Indeed, the question may determine whether these useful new securities will be able to be marketed at all in the United States. Under the CEA, no one can trade a futures contract in the United States otherwise than on a board of trade designated by the CFTC as a "contract market" for the instrument or otherwise than through a member of such contract market.[15] Section 4a of the CEA, 7 U.S.C. §6a(1) (1988). This means that there will be no trading in the United States in any new instrument that might be deemed to be a futures contract as well as a security unless a commodity board of trade sponsors the instrument and is able

[15] In contrast, securities may be traded on exchanges, in the over-the-counter market, or in privately negotiated transactions—whether through broker-dealers or not—provided only that if such trading takes place through the facilities of an exchange or other self-regulatory organization, it must do so in conformity with rules of the organization that have been approved by the SEC.

to obtain the CFTC's approval for the right to trade it.[16] It also means that the new products could be lawfully marketed only by persons qualified under the CEA to act as brokers and salesmen, and that the much larger group of persons who are qualified under the Exchange Act to act in those capacities will be unable to market this product. Finally, as the SEC found, many investors also may be effectively prohibited from participating in futures markets as a result of regulatory constraints or contractual prohibitions. (App. 61). All of this means that, as a result of the Court of Appeals holding, these useful new securities may not be available at all in the United States.

If they are made available, but only on futures exchanges, they will be less useful as a result of being placed under a regulatory scheme designed for a very different type of product, and the form of the instrument would undoubtedly have to be changed. For example, the IPs designed by AMEX give purchasers a privilege to obtain physical delivery of the stocks comprising the underlying index. The SEC found that the availability of this privilege permits institutions to use these IPs to adjust their stock portfolios and that, as a result, these IPs have a greater potential for providing the liquidity benefits envisioned for market baskets. (App. 69). Yet, because these securities have been held to be futures contracts from the sellers' perspective and subject

[16] It is not clear that the CFTC's rules would permit it to grant such approval for products like IPs. In order to qualify for continued designation to trade, a futures contract must be shown to have "served a hedging or price basing function on more than an occasional basis." 17 C.F.R. Part 5, Appendix A, item C(5) (1989). IPs were designed primarily as investment vehicles for retail customers. The substantial up-front costs involved in purchasing and selling IPs make them unsuitable for hedging and price discovery functions, which are much more efficiently performed by stock index futures.

to the exclusive jurisdiction of the CFTC, this valuable physical delivery feature cannot be incorporated into the instrument.[17]

The uncertainty created by the Court of Appeals opinion as to which regulatory scheme will apply to innovative securities products leaves participants in the securities markets in a quandary. A securities exchange that wishes to become a market for the trading of an instrument that might be argued to be a futures contract as well as a security cannot be sure with which federal agency it should file for approval, and the agencies themselves do not know whether they should process the filings. Even if one agency should approve a particular proposal, until the questions presented by this case are definitively settled by this Court, no participant in the markets can be confident that its actions in conformity with one federal regulatory scheme will not be held to be in violation of the other. The development and introduction of new securities products involve substantial time, effort, and expense. Jurisdictional confusion and questions as to legality can only delay the introduction of new securities products that could serve important economic purposes and help maintain the competitiveness of the financial markets of the United States.[18]

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[17] Section 2(a)(1)(B)(ii)(I) of the CEA, 7 U.S.C. §2a(ii)(I) (1988), provides that no board of trade may be designated as a contract market for stock index futures contracts or options thereon unless "[s]ettlement of or delivery on such contract (or option on such contract) shall be effected in cash or by means other than the transfer or receipt of any security . . . ."

[18] IPs are being traded in the over-the-counter market in Canada and on the Toronto Stock Exchange. According to one report, this was possible because "Canadian regulators have managed to avoid the turf battle that engulfed" the IPs designed by PHLX and AMEX. *Investor's Daily*, March 19, 1990, at p. 11.

II.

THE COURT OF APPEALS HOLDING CREATES UNCERTAINTY AS TO THE MEANING OF "FUTURES CONTRACT," CASTS DOUBT UPON THE EXTENT OF THE SEC'S JURISDICTION OVER BOTH NEW AND EXISTING INVESTMENTS, AND FRUSTRATES THE INTENT OF CONGRESS.

The CEA grants exclusive jurisdiction to the CFTC to regulate transactions involving "contracts of sale of a commodity for future delivery" (that is, "futures contracts"). CEA §2(a)(1)(A), 7 U.S.C. §2 (1988). Except for this grant of exclusive jurisdiction over futures contracts, the CEA provides that nothing contained therein "shall (i) supersede or limit the jurisdiction at any time conferred on the [SEC] or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the [SEC] and such other authorities from carrying out their duties and responsibilities in accordance with such laws." *Id.* This latter provision is sometimes referred to as the "SEC saving clause."

This jurisdictional scheme was added to the bill that created the CFTC by an amendment proposed by the Senate Committee on Agriculture and Forestry. In describing the exclusive jurisdiction clause, Senate Report No. 93-1131 stated:

> While the Committee did wish the jurisdiction of the [CFTC] to be exclusive with regard to the trading of *futures on organized contract markets,* it did not wish to infringe on the jurisdiction of the [SEC] or other government agencies.

S. Rep. No. 1131, 93rd Cong., 2d Sess., at 3, *reprinted in* 1974 U.S. Code Cong. & Admin. News 5843, 5863 [emphasis supplied].

Thus, the issue boils down to what Congress meant by "futures" when it enacted this provision granting the CFTC exclusive jurisdiction over "futures" but otherwise not wishing to infringe on the SEC's jurisdiction. Are futures to be defined in some amorphous, expansive way, as the Court below did, with the result that the SEC's jurisdiction over a wide array of new and traditional financial instruments is shifted to the CFTC, or are they to be defined in reference to the type of instrument that Congress described when this jurisdictional provision was added to the CEA?

Unfortunately, the CEA contains no definition of futures contract. The Senate Report contains a glossary definition of futures contract,[19] but it warns that the glossary is not to be deemed a guide to interpretation of the CEA or statements in the Report. *Id.* at 5891. Nevertheless, the Senate Report describes futures trading in a manner similar to the glossary definition, saying: "Futures trading involves purchases and sales of contracts for delivery at some future date of certain quantities of specified commodities at fixed prices." *Id.* at 5856. The Senate Report also describes the manner in which daily payments are made between the futures clearing house and its members to reflect daily price changes in futures contracts, a manner which is incompatible with IPs and other securities.[20] *Id.* at 5858.

In deciding that IPs are futures contracts subject to the exclusive jurisdiction of the CFTC, the Court of Appeals furnished a definition of a "futures contract." It stated:

> A futures contract, roughly speaking, is a fungible promise to buy or sell a particular commodity *at a fixed date in the future.* (App. 8-9). [Emphasis supplied.]

[19] The glossary defines "futures contract" as "contracts for the purchase and sale of commodities for delivery some time in the future on an organized exchange and subject to all terms and conditions included in the Rules of that Exchange." *Id.* at 5892.

[20] *See* n. 5, supra.

However, the Court neither followed that definition nor supplied a new one.[21] The reasons the Court gave for finding that IPs are futures contracts provide little guidance other than to suggest that the application of the securities laws to a wide range of securities is now suspect.

First, the Court of Appeals noted that there was a congruence of futures and IPs from the perspective of their sellers.[22] (App. 15-16). However, there is at least as great a congruence of standardized options and IPs from this same perspective, and the Court rejected the notion that IPs are options.[23] Three types of instruments—futures contracts, options and IPs—all have similarities from their sellers' viewpoint. Yet, although it is plain that options are not futures and futures are not options, the Court held that IPs are futures contracts and not options. The Court stated that the

[21] It is clear that IPs are *not* contracts to buy and sell the value of the underlying index "at a fixed date in the future." The dates on which IP sellers are obligated to pay the value of the underlying index are not fixed in advance. Rather, they are determined by when IP holders choose to exercise their privileges to receive the value of the underlying index.

[22] The Court of Appeals found IPs to be securities from the perspective of the buyers and futures contracts from the perspective of the sellers, but it held that neither "is the 'privileged' perspective." (App. 109). In so holding, the Court ignored Section 2(a)(1)(B)(i) of the CEA, which provides that the CEA shall not apply to "any transaction whereby any party *acquires* any put, call or *other option* on one or more securities . . . , including any group or index of such securities, or any interest therein or based on the value thereof." 7 U.S.C. §2(a)(i) (1988) [emphasis supplied]. Clearly, Congress intended the perspective of the acquiring party to be controlling for jurisdictional purposes.

[23] One of the reasons the Court gave for holding that IPs were not options is that IPs have indefinite duration while, as the Court held, options are "limited in time." (App. 18). However, futures contracts are also limited in time, and the Court leaves uncertain why it is dispensing with the "fixed date in the future" requirement for futures but not for options.

"very features that the SEC emphasizes to show that IPs are securities—indefinite duration, payment up front in cash, dividend equivalency, and so on—show that IPs cannot be options." (App. 18). But these same features should distinguish IPs from futures contracts as well, since futures contracts long have had the attributes of fixed term, no payment up front and no dividend equivalency. What is unclear is why these features can be ignored in considering whether an instrument is a futures contract but given great weight in considering whether it is an option.

Second, the Court of Appeals rejected the one element that distinguishes a futures contract from an option—namely, "bilateralism." (App. 21). Traditional futures contracts—that is, the kind described in the Senate Report (*supra*, at 16)—are bilateral. Both the buyer and the seller are obligated to perform at some fixed future date. On the other hand, an option is not bilateral; although the seller is obligated to perform at some future date, the buyer is not. Thus, the sellers of futures and of options have the same obligations; the instruments differ only from the viewpoint of the buyer. The CFTC, in its brief as *amicus curiae*, characterized bilateral obligation as an "essential element of a futures contract."[24] The Court of Appeals recognized that "bilateralism" was missing in IPs, but held that bilateralism was not essential to a futures contract notwithstanding the CFTC's express statement that it was (App. 21). Thus, the Court in effect merged futures and options by eliminating the one element that distinguished them, thereby throwing into further uncertainty the means of fixing the line between the two types of products.[25]

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[24] Brief of Commodity Futures Trading Commission as *Amicus Curiae* at 15.

[25] The Court recognized that "it is almost always possible to devise an option with the same economic attributes as a futures contract (and the reverse)." (App. 11).

Third, the Court of Appeals found IPs to have "futurity" in the sense that their holders have the privilege to exercise the IP on a future date and to receive the value of the underlying index on that date. (App. 16). If this is the type of "futurity" that turns a security into a futures contract, then it will remove a wide array of securities from the application of the securities laws. For example, an option on a stock index that is exercisable only at expiration (called a "European-style option")—which is a type of option issued by OCC under SEC regulation—obligates the short to pay the value of the index at expiration if the option is exercised, which it surely will be if it is "in the money" at expiration. The obligations of the sellers of IPs and the writers of such European-style options are indistinguishable. Similarly, the holder of shares of an open-end mutual fund has the right to redeem his shares each day in the future and to receive the value of his proportionate share of the fund's portfolio on the date he redeems. Other examples include zero-coupon bonds (where the holder pays a present value in exchange for the right to be paid a future value at a specified future date); index warrants (where the holder has the right to be paid an amount based on the value of a specified index at some future date);[26] and variable annuities (where the holder is entitled to future payments based on the values accumulated over time). It would seem clear that mere "futurity" does not make a futures contract,[27] but what more is needed remains uncertain under the Court of Appeals opinion.

[26] These types of warrants are now listed on AMEX, and the New York Stock Exchange is applying to the SEC for approval to list similar types of warrants. These warrants have been among the most actively traded issues on AMEX since trading began on February 15, 1990.

[27] Indeed, virtually every exchange contract for the purchase of a security involves "futurity" in the sense that delivery and payment will be made "at a fixed date in the future." Congress obviously intended that there be something more than a reliance on the word "future."

The Court of Appeals in effect acknowledges this when it states:

> Fact is, it is no less a future than it is a security, and no more. It just doesn't fit. (App. 17).

And when it says:

> "These products are valuable to the extent that they do *not* match the attributes of instruments already available." (App. 13). [Emphasis in original.]

Later, the Court says that "the IP is both a security and a futures contract. It has some attributes of both, and all attributes of neither . . . ."[28] (App. 20). It then decides that the definition of "futures contract" should be no less broad than the definition of "security."

The exclusive jurisdiction clause of the CEA is strong medicine. It exempts an instrument from regulation under every federal and state regulatory statute except the CEA. Applying it to instruments that are offered, traded, cleared, and settled as securities, that are expressly found by the SEC to be securities, that are futures contracts only under a strained and expansive interpretation of that term, and that did not even exist when Congress enacted the exclusive jurisdiction clause, is surely not what Congress intended.[29] The SEC saving clause evinced a concern on the part of Congress that the jurisdiction of the SEC not be limited by the CEA "except as hereinabove provided"—*i.e.*, except to the extent required by the exclusive jurisdiction clause. That clause

28 Since the SEC expressly found that IPs were designed as investments for retail customers (App. 69 n. 96), it would seem that they do have all the attributes of a security under the doctrine of *Reves v. Ernst & Young*, *supra* n. 8.

29 The Court of Appeals itself suggested that Congress might think it wise to "relax" an exclusivity clause interpreted as broadly as the Court of Appeals interpreted it. (App. 109-10).

gives the CFTC exclusive jurisdiction over transactions involving "contracts of sale of a commodity for future delivery." To interpret that phrase expansively, as the Court of Appeals did, so that it encompasses not only the types of futures contracts described in the legislative history that accompanied the enactment of the exclusive jurisdiction clause,[30] but also entirely new financial instruments that are clearly securities, is to reduce the SEC saving clause to a nullity.

If the Court of Appeals decision is to stand—if instruments are to be deemed to be futures contracts because they have some similarities to futures contracts (while the differences are ignored)—then the intent of Congress in enacting the SEC saving clause will be frustrated and the extent to which both new and existing securities will be subject to the securities laws will remain uncertain.

III.

THE COURT OF APPEALS IGNORED, AND HAS THEREBY IN EFFECT REPEALED, ONE OF THE PRINCIPAL JURISDICTIONAL PROVISIONS OF THE EXCHANGE ACT.

In the 1982 amendments to the securities laws, Congress expanded the definition of "security" in Section 3(a)(10) of the Exchange Act, 15 U.S.C. §78c(a)(10) (1988), and in the other securities laws to make it clear that any "privilege on any . . . group or index of securities (including any interest therein or based on the value thereof)" is itself a security for the purposes of the securities laws. The 1982 amendments then added a new Section 9(g), 15 U.S.C. §78i(g) (1988), which provides that "[n]otwithstanding any other provision of law," the SEC is to have the authority to regulate the trading of "any put, call, straddle, option, or privilege on any

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[30] *See* n. 19 and accompanying text, *supra*.

. . . group or index of securities (including any interest therein or based on the value thereof)." It is clear from the legislative history that only the SEC, and not the CFTC, was to have authority with respect to these types of instruments.[31]

The term "privilege" is not defined in the Exchange Act. However, its juxtaposition in Section 9(g) with the terms "put," "call," "straddle," and "option" suggests that it was intended to refer to an instrument conveying rights similar, but not identical, to those conveyed by an option. The rights conveyed by IPs fit that description. As the SEC noted:

> To the extent certain IP characteristics differ somewhat from the characteristics of stock, they resemble characteristics commonly found in rights to purchase or puts or calls on a security or index of securities . . . . (App. 52).

The Court of Appeals itself expressly stated that "IPs convey privileges based on the value of an index" (App. 15). Yet it failed entirely to consider the applicability of Section 9(g). Instead, it merely concluded—notwithstanding the many ways in which the SEC found IPs to be similar to standardized options (*supra*, at 5-6)—that IPs were not "options."[32]

In the allocation of jurisdiction between the SEC and the CFTC, it is important to eliminate any uncertainties concern-

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[31] H.R. Rep. No. 626, 97th Cong., 2d Sess., pt. 1 at 9 and pt. 2 at 11-16, *reprinted in* U.S. Code Cong. & Admin. News 2780, 2787 and 2801-6.

[32] If, as the Court of Appeals says, it is not going to apply *strictissimi juris* to the CEA (App. 23), why does it do so with respect to this important provision of the Exchange Act? The Court incorrectly implies that the SEC found that IPs are not "options." (App. 17). The SEC expressly noted that IPs have characteristics of options (App. 52 n. 57) and, as noted above, that IPs have characteristics resembling those commonly found in puts or

(Footnote continued on following page)

ing the meanings of the terms used in jurisdictional provisions such as Section 9(g), and not simply to ignore the entire issue. Although IPs contain a "privilege" which brings them within the literal language of Section 9(g) of the Exchange Act, the Court of Appeals persistently disregarded Section 9(g) and assigned jurisdiction as though it had never been enacted.[33] This Court should examine the Court of Appeals' implicit repealer of Section 9(g).

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[32] *continued*
calls (App. 52). Moreover, the SEC specifically eschewed pigeonholing IPs exclusively into any of the specific definitions contained in Section 3(a)(10) of the Exchange Act; it identified a variety of instruments described in the Exchange Act to which IPs can be analogized, and did not foreclose the possibility that IPs could fit within other categories under Section 3(a)(10). (App. 48 n. 47). *Tcherepnin v. Knight*, 389 U.S. 332, 339 (1967) (an instrument may simultaneously fit within several of the enumerated definitions under Section 3(a)(10)).

[33] *See* n. 11, *supra*.

CONCLUSION

The Court of Appeals has erroneously decided important questions of federal law which should be reviewed and settled by this Court. Petitioners respectfully request that a writ of certiorari issue to review the judgments of the Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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